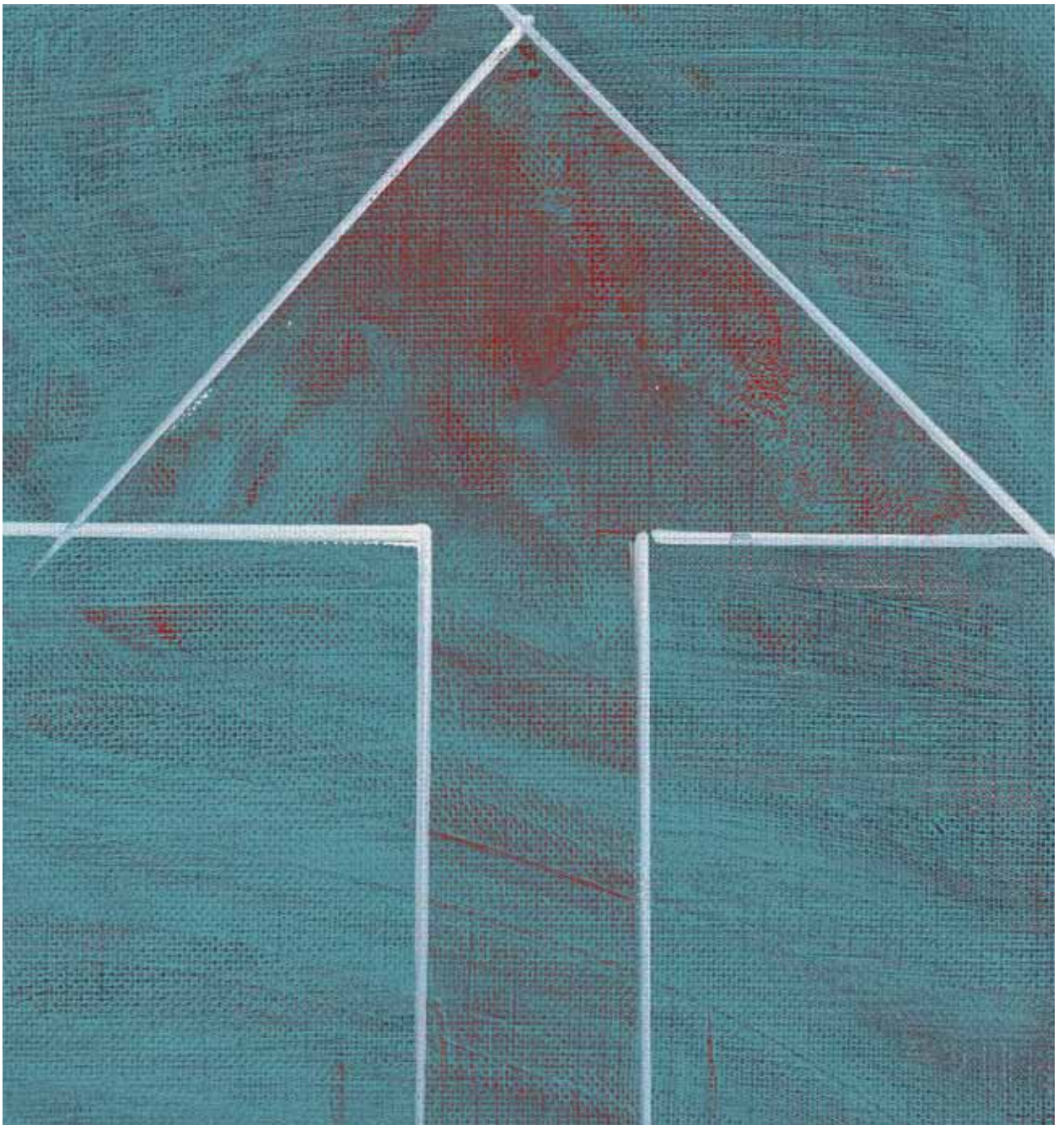
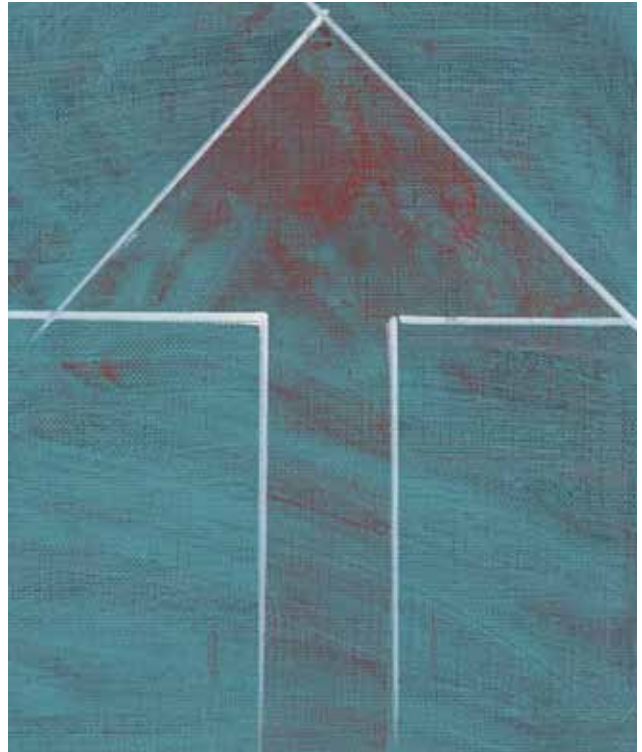

Innovative Ideas for Revitalizing the LIHTC Market



INNOVATIVE IDEAS FOR REVITALIZING THE LIHTC MARKET



The views expressed here are those of the authors and not necessarily those of the Board of Governors of the Federal Reserve System or the Federal Reserve Bank of St. Louis.

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FOREWORD

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Given the adverse impact of the current economic conditions on homeownership, the development of rental housing is becoming increasingly important, not only to provide homes for families, but also to help stabilize neighborhoods.

The Federal Reserve System, because of its interest in maintaining economic stability, has long had an interest in the Low Income Housing Tax Credit (LIHTC) program, a major source of capital for the development of rental housing. The Fed's Community Affairs function is particularly focused on stability and opportunity in low-income communities. This includes sustaining the production of affordable rental units during the economic downturn. To that end, the Board of Governors' and the Federal Reserve Bank of St. Louis' Community Affairs functions have commissioned a series of short articles by practitioners and experts to highlight their ideas for bolstering the LIHTC program.

This publication presents six ideas to strengthen the LIHTC market. John Wuest reviews the St. Louis Equity Fund's strategies to continue developing LIHTC projects despite the market downturn. Buzz Roberts of the Local Initiatives Support Corp. (LISC) suggests ways the Community Reinvestment Act could be altered to attract increased investment in LIHTCs by financial institutions. Joseph Flatley of the Massachusetts Housing Investment Corp. proposes restoring the market for LIHTC projects through federal co-investment in the tax credit. Ian Galloway of the Federal Reserve Bank of San Francisco builds a case for using innovative ways to expand the LIHTC investor pool to individual investors. Shekar Narasimhan of Beekman Advisors offers a secondary market solution to bring additional investors into the market. Finally, Debra Schwartz of the MacArthur Foundation highlights a promising model for an "enhanced" structure for a LIHTC fund that would provide equity for high-quality projects.

The development of this publication was helped considerably by Linda Fischer of the Federal Reserve Bank of St. Louis and David Erickson of the Federal Reserve Bank of San Francisco whose knowledge and editing contributions were invaluable.

BACKGROUND

The Low Income Housing Tax Credit (LIHTC) program is the federal government's primary tool for financing the development of affordable rental housing for low- and moderate-income households. Over the past 20 years, these tax credits emerged as the leading source of capital subsidy for the construction and rehabilitation of such housing. Using equity investments from public-private partnerships, the LIHTC program has created over 2 million housing units since its inception. Furthermore, until the recent economic downturn, the program peaked at financing and constructing approximately 100,000 rental units per year.

The LIHTC program was established under the Tax Reform Act of 1986 to encourage the investment of private equity in the development of affordable rental housing. The program uses an indirect subsidy to promote private investment in the development of low-income rental housing by providing a dollar-for-dollar credit against tax liability. The subsidy makes it possible for both private and nonprofit developers to build high-quality housing with affordable rents.

LIHTC allocations are administered at the state level, with each state receiving a fixed number of credits based primarily on its population. Each state designates an agency, typically the state housing finance agency (HFA), to allocate the credits to applicants based on its Qualified Allocation Plan. The state may use the plan to support specific policy agendas, such as promoting geographic targeting for rural or distressed urban neighborhoods.

The LIHTC program provides two types of tax credits. Most new construction and substantial rehabilitation projects are eligible for the "9 percent" credit that allows investors to claim credits for 9 percent of qualified project construction costs annually over a 10-year period. The "4 percent" credit is used for projects that are financed in conjunction with tax-exempt bonds and other gap subsidies. Typically, LIHTC projects receive the vast majority of financing through the tax credits.

The tax credits are intended for permanent rental housing projects that meet one of the following occupant income-eligibility requirements. Under the "20-50 Rule," at least 20 percent of the units must be occupied by households with incomes at or below 50 percent of the area median income (AMI). Likewise, the "40-60 Rule" provides for projects with at least 40 percent of the units rented to households with incomes at or below 60 percent of the AMI. In most cases,

100 percent of units are affordable. All units receiving LIHTCs have rent restrictions based on the number of bedrooms, household size and household incomes. Rent and income restrictions are applicable for a minimum of 15 years.

A competitive market for the purchase of tax credits arose primarily from the developers needing to sell credits to raise equity capital for projects. In most sales, syndicators are used to assemble a group of investors for the developer and to certify or guarantee project compliance for the investors. Individual investors are restricted in their use of LIHTCs. As a result, most credits are purchased by widely held C corporations, which use the credits against any amount of tax liability. Because LIHTC investments are considered qualified investments under the Community Reinvestment Act (CRA), a large portion of the investors are regulated financial institutions. Traditionally, government sponsored enterprises (GSEs) have also been strong investors in LIHTCs, which helps them meet affordable housing requirements established by their regulator.

Challenges Facing the LIHTC Market

Since the recent economic downturn, the LIHTC syndication market has experienced severe distress due to a lack of investor interest in the credits. Traditionally, the market for LIHTCs has been concentrated among relatively few major investors. Therefore, losing one or two investors in the market can have a large impact on pricing and the ability for deals to be sustainable. Many banks, the main investors in LIHTCs, have drastically reduced their investment in LIHTC projects as their need to offset taxable income has declined. Likewise, a large drop-off in tax credit purchases by the GSEs, which previously comprised about 40 percent of the market, has also contributed to the recent decline in LIHTC market volume. Many experts now estimate that the size of the market for LIHTCs in 2009 will be less than half the size it was in 2007, dropping from around \$9 billion to less than \$4.5 billion.

In the current economic environment, low investor demand for tax credits has led to multiple challenges for the affordable rental housing production market. With a glut of tax credits available, the price paid to developers of housing projects by investors recently dropped from over 90 cents per credit to lower than 70 cents. The drop in price received by housing developers means that money must be made up elsewhere to close project financing gaps. This is a difficult proposition given that the pool of equity investors and debt sources continues to shrink. Many projects planned

for higher tax credit income now must be slowed or stopped as the math no longer “pencils out.” The resulting decline in LIHTC production likely means thousands fewer affordable apartment units built last year and this year.

Efforts to Revitalize LIHTCs

A number of federal efforts are under way to stabilize and revitalize the LIHTC program. For example, the American Recovery and Reinvestment Act (ARRA) of 2009 included two provisions designed to improve the functionality of LIHTCs for currently planned, but stalled, developments. These provisions are intended to fill the financial gap created by the reduction in value of the tax credits.

First, the Tax Credit Exchange Program (TCEP), administered by the U.S. Department of the Treasury, provides grants to states in lieu of non-used credits at a price of 85 cents per dollar over 10 years. Many analysts estimate that housing developments will receive about \$3 billion under the program in 2009. However, there are some indications that a number of states are not planning to use the TCEP due to the program’s complex structure. The program is authorized for 2009 and may be extended for another year by Congress because many organizations are organizing to support this provision. Second, another temporary program, the Tax Credit Assistance Program (TCAP) provides an additional \$2.25 billion in Home Investment Partnership Program funds from HUD to fill in the growing financing gaps in LIHTC transactions.

Additional ideas for stimulating the LIHTC market include a proposal for the Treasury to extend the LIHTC carryback period. Tax credits would hold their value today regardless of whether the tax credit investor is currently booking profits. This is relevant as many equity investors in LIHTCs are forecasting sharply lower income tax liabilities for 2009 and beyond. This provision would require a legislative change to allow current tax credits to be used against investor profit made during any of the last five years. Current law allows LIHTC benefits to be carried back one year and carried forward 20 years. The industry is also proposing that Congress extend the TCEP for another year and include the “4 percent” tax credits. ■



THE ST. LOUIS EQUITY FUND AND LIHTCS: PAST AND FUTURE

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Now, more than any time since the creation of the Low Income Housing Tax Credit (LIHTC) program, there is a need to build safe, decent, affordable housing. With the country in the throes of an economic downturn, there is a new group of individuals and families who could well utilize the housing created by these tax credits. The question is: Can the program survive?

When Congress passed legislation in 1986 establishing LIHTCs, the intent was to promote the construction of affordable rental housing throughout the country. The tax credits would accomplish this by partially shifting the responsibility for building such housing to the private sector. Most agree that the program has been very successful in accomplishing this goal.

However, during the current recession, a large disruption in the overall tax credit market has occurred, resulting in a dramatic reduction in the price being paid for each credit. Consequently, insufficient funds are being generated by the sale of the credits to successfully complete projects. While it is true that the reduction in the price paid for the credit raises the yield to the investor, from a practical standpoint, if the project cannot be built, neither investor nor general partner benefits in that there is no transaction.

It's Not All Bad News

Despite the economy, the St. Louis Equity Fund (SLEFI) has not experienced a significant disruption in the flow of investment capital and plans to continue providing affordable housing for communities.

The equity fund has strong support from local financial institutions and corporations. In 2008, SLEFI raised approximately \$24 million from 22 investors. In addition, SLEFI formed the Kansas City Equity Fund (KCEF) in 2007, which has raised an additional \$7 million from Kansas City based financial institutions. SLEFI is currently working on a plan with the Missouri Bankers Association to contact banks in out-state Missouri with the idea of forming a separate fund. This fund would be available to invest in transactions that receive LIHTC allocations in the more rural areas of the state.

SLEFI was the idea of a group of St. Louis civic leaders who thought it would be very positive for the city if an entity could be formed to syndicate LIHTCs. This entity would have the dual mission of protecting the investment while providing affordable housing that otherwise may not be produced. Desiring to move forward, they petitioned a civic organization in St. Louis for a \$75,000 grant. The grant would serve as the seed money for SLEFI's first annual fund in 1988, raising \$3.25 million and facilitating the production of 105 affordable housing units.

Since that time, SLEFI has formed an annual fund for all but one year. During its 20-year history, SLEFI has raised more than \$240 million for the production of 3,442 housing units. These units have a total development cost of \$443 million, and it is estimated this economic activity has created in excess of 5,000 jobs.

The reason the fund has not felt the full impact of the slumping LIHTC market may be that it has a broad base of smaller investors—22 in the 2008 fund—so that losing one or two is not catastrophic. However, there are two or three larger investors that would obviously have a larger effect if they dropped out.

Bolstering the LIHTC Market

In an effort to mitigate the adverse conditions in the LIHTC market, the Administration included two provisions in the American Recovery and Reinvestment Act (ARRA) to ensure the continued production of affordable housing. They are the Tax Credit Exchange Program (TCEP) and a mechanism for gap financing known as the Tax Credit Assistance Program (TCAP).

The exchange provision allows the state housing credit allocating agency, in our case the Missouri Housing Development Commission, to exchange up to 40 percent of its 2009 volume cap credits and 100 percent of any unused 2008 credits for cash at the rate of 85 cents on the dollar. According to the Congressional Budget Office, this could generate as much as \$3 billion in additional funds for the construction of new projects. The 85 cents compares to a market price today in the range of 65 cents.

The second provision, TCAP, will make \$2.25 billion of HUD Home Funds available to assist in providing the additional gap funds to permit completion of projects. The funds will be distributed by and administered through the traditional LIHTC distribution channels following all of the LIHTC protocols. In allocating these funds, priority is to be given to projects that will be finished within three years of the date of passage of ARRA. The funds will be distributed to states with the same formula used for the

distribution of the 2008 Fiscal Year Home Funds. The state agencies will be required to commit a minimum of 75 percent of the funds within a year of the enactment date of ARRA, and 75 percent of the funds must be spent within two years of this enactment date. Any unused funds will be recaptured after three years.

While there are still many questions concerning the implementation of these programs, the general consensus seems to be that they both will be helpful in ensuring the continued production of affordable housing. SLEFI has several projects in its pipeline that will be helped significantly by using these programs.

However, some concern still remains in the marketplace regarding the overall availability of investment capital. The original draft of ARRA included two provisions designed to facilitate the flow of capital. The first would have allowed investors to carry back, for up to five years, tax credits earned in 2008 and 2009. The second

was an acceleration of the recognition of the credits, allowing the owner of the credits to claim 60 percent of the project's LIHTC credits in the first three years of the investment and the remaining 40 percent over the next seven years. Unfortunately, neither provision made it into the final legislation, primarily because of the associated costs. The current wisdom is that Congress will consider another housing bill in the coming months and that there will be a concerted effort to include these provisions in the new legislation, as previously mentioned.

However, it might not be acts of Congress alone that revive the LIHTC market. The restoration of confidence in the financial markets will go a long way toward creating interest. In addition, when banks are satisfied that they have identified most of their loan problems and have provisioned for them properly, they will be more aggressive in seeking opportunities to shelter future income. ■



MODIFYING CRA TO ATTRACT LIHTC INVESTMENTS

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Multi-regional banks, motivated by the Community Reinvestment Act (CRA), remain the primary Low Income Housing Tax Credit (LIHTC) investors today, although some banks have scaled back investments because their financial condition limits their ability to use tax credits and motivates them to conserve capital. However, CRA has been less effective in attracting regional and local banks as investors that could restore balance to the LIHTC investment market. Moreover, CRA is contributing to a geographic skewing of investments—many markets are facing serious shortages of capital while a few places have plentiful capital.

Modest changes to CRA policy could provide a significant stimulus to bank investment in LIHTCs, especially from regional and large local banks. In particular, policy changes should ensure that banks receive full CRA recognition for investing in nationwide or regional funds with geographies well beyond their immediate assessment areas. The changes would benefit all communities, and especially rural and disaster areas, small and mid-sized metropolitan areas, and states served by few multi-regional banks.

Before the Economic Downturn

Prior to the recent economic downturn, about 40 percent of LIHTC investments came from banks and about 40 percent came from Fannie Mae and Freddie Mac (combined). Among banks, a limited number of very large, multi-regional banks were the primary investors. These institutions shared a familiarity with rental housing finance; a relatively low cost of funds; a willingness to make long-term investments with uncertain liquidity; a desire for good public relations; and, for banks, CRA recognition.

Corporations had been investing in multiple projects through nationwide or regional funds (multi-investor funds) for several years. These funds offered investors risk diversification, centralized underwriting and asset management. Corporations also gained confidence from co-investing with other experienced, sophisticated investors.

The system generally worked well. Investor demand was high, driving down yields to investors and driving up investment proceeds to project sponsors. Projects in all parts of the country attracted investment on competitive terms, even if they were located in inner cities or rural areas. The properties performed better than other classes of real estate, with the national annual LIHTC foreclosure rate below 0.1 percent. If anything, the system may have worked too well, as yields dipped unsustainably low and large investors crowded out smaller ones.

CRA Policy and LIHTC Investments

In general, a bank receives CRA credit for LIHTC and other community development investments that “benefit its assessment area(s) or a broader statewide or regional area that includes the bank’s assessment area(s).”¹ A 1997 interpretive letter issued jointly by the four federal banking agencies appeared to endorse regions as broad as a quadrant of the country, such as the Northeast, South, Midwest and West.² These policies made it easier for banks to receive CRA recognition for LIHTC investments.

However, the more detailed Interagency Question and Answer (Q&A) guidance subsequently sent mixed signals.³

On one hand, the agencies tout the value of nationwide and regional community development funds. The Q&A even assures banks that a fund’s activities need not directly benefit a bank’s assessment area or the surrounding region—as long as the fund’s geography includes the bank’s assessment area.

On the other hand, the agencies direct bank examiners to discount CRA recognition for such investments if the region is large, depending on the actual and potential benefit to a bank’s assessment area. In addition, a bank receives credit for regional investments only if it is adequately addressing its assessment areas’ needs, which a subsequent examination will determine. In other words, a bank would receive credit for investments in large regional or nationwide funds, but perhaps not much credit unless its assessment areas directly benefit.⁴

This policy makes it difficult for a bank considering an investment to predict how its regulator will treat it in an examination a year or two later. However, the syndicators that manage the multi-investor funds were

¹ See, e.g., 12 CFR 288.23 (a).

² Interpretive Letter 800.

³ Interagency Questions and Answers Regarding Community are released periodically by the staffs of the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corp., Office of the Comptroller of the Currency, and Office of Thrift Supervision to provide guidance to financial institutions and the public. See www.ffiec.gov/cra/qnadoc.htm

⁴ See Community Reinvestment Act; Interagency Questions and Answers Regarding Community Reinvestment; §__12(h)–6 and -7.

able to make the policy work as long as they could also attract investors not constrained by CRA policies, such as Fannie Mae and Freddie Mac. By pooling investments, syndicators could ensure that banks received CRA credit in their assessment areas and, in effect, invest some Fannie and Freddie money where no bank investor could get or needed CRA recognition. In this way, rural areas, small and mid-sized metropolitan areas, and states not served by the largest banks could still attract investment on competitive terms.

Multi-regional banks with numerous assessment areas could be reasonably confident that a nationwide or regional investment fund would finance at least some projects in some of the banks' assessment areas, assuring CRA recognition. However, the system did not work as well for most regional and local banks because they could not be sure the fund would invest in their areas, and some were surprised when examiners denied CRA recognition for fund investments, sometimes even within the same metropolitan area. In any case, the multi-regional banks—along with Fannie, Freddie and some other nonbanks—provided enough capital to make the system work until recently.

LIHTC Challenges in the Current Economy

When Fannie and Freddie encountered financial problems and withdrew from the market starting in late 2007, the direct impact was a 40 percent gap in the market that needed to be filled. However, CRA geographic targeting requirements hurt efforts to raise new investments from regional and local banks in the absence of nonbank co-investors.

Most syndicators have curtailed investment in places outside the banks' CRA priority areas. With few nonbank investors, it has become difficult or impossible to support housing in most rural areas and small and mid-sized cities, since these areas tend to attract little attention when the largest banks are examined. Housing sponsors in some markets with strong bank presence could not attract investment if the banks had already done enough to meet CRA obligations. Moreover, housing in the Gulf Opportunity Zone and other disaster areas, where Congress had allocated additional LIHTC authority, could not attract much investment because few major banks needed CRA credit there. Special regulatory guidance allowing banks nationwide to get CRA credit for investing in the Gulf Opportunity Zone did not generate much response.

In addition, multi-regional banks are tending more to invest directly or enlist syndicators to form proprietary or "private label" funds and are less likely to participate in multi-investor funds. This allows them

to maximize CRA recognition and cross-market loan products to project sponsors. Some multi-regional banks have also decreased their overall LIHTC investment activity because of reduced capacity to use tax credits and a need to conserve capital.

As a result, regional and local banks that could enter the market have few good vehicles for generating CRA recognition. These banks want to see live projects in their CRA assessment areas before committing to a regional or nationwide fund. Yet, a bank unfamiliar with LIHTCs usually requires six months to a year to make a LIHTC investment decision after a CRA-relevant project appears. Most sponsors and syndicators cannot wait that long for a bank's decision. Regional and local banks also usually lack the capacity to invest on their own and probably cannot commit enough money for a syndicator to create a single-investor or proprietary fund for them.

A CRA Solution

Regional and nationwide LIHTC funds could provide an improved vehicle to increase LIHTC investments, especially by regional and local banks, provided these institutions could be guaranteed full CRA credit for their investments. Technical changes to the Q&A on geographic targeting of LIHTC investments could motivate additional participation from financial institutions in regional funds.

Policy changes to CRA could include the following provisions:

1. **CRA credit should be given for a LIHTC investment made through a fund serving a region that includes any of the bank's assessment areas.** CRA credit should be given unless the bank has received a rating below satisfactory on its latest CRA exam. In other words, if the bank has met its past CRA obligations for its assessment areas, it should be given full CRA credit for investments in regional funds. This approach would offer predictability for investors, but not allow them to ignore local needs.
2. **CRA credit should not be discounted for investments benefiting a large regional area.** As previously explained, the Q&A suggests that examiners discount CRA credit for participating in a fund that serves a large area because the benefit to a bank's assessment area may be diffused and, therefore, unresponsive to assessment area needs.⁵ This uncertainty discourages bank investments through such funds.

⁵ Interagency Q&A § __.12(h)-7.

3. **Banking regulating agencies should make it clear that an eligible region may be as large as a quadrant of the country.**⁶ To maintain bank investments, eligible regions must be large enough to accommodate multiple bank participants and diversify risks, resulting in more efficient management. Defining region as a quadrant would assuage these fears and could increase investment. ■

⁶ This definition would be consistent with Interagency Interpretive Letter 800.



FEDERAL CO-INVESTMENT IN LIHTC PROPERTIES

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The Low Income Housing Tax Credit (LIHTC) market has experienced a serious downturn in recent months. Political actions are needed to stimulate the market and respond to the demand for the development and preservation of affordable rental housing. The federal government has an opportunity to correct the supply-and-demand disparity by co-investing in LIHTC properties and restoring a market for viable projects.

Rationale

The LIHTC program is the major federal program supporting the production and preservation of low-income rental housing. Today, the LIHTC market is experiencing a substantial lack of investor demand. The current challenges facing the banking industry, coupled with the conservatorship of Fannie Mae and Freddie Mac, have created an enormous shortfall in demand. It is estimated that more than 60 percent of the investor demand available in previous years will not be available in 2009, with a similar, though improving slightly, outlook for 2010. As a result, many projects that have received LIHTC allocations from states are unable to secure sufficient investor commitments to proceed.

Concern about the lagging LIHTC market has generated actions and proposals to enhance and expand investor interest in the program. For example, Congress provided short-term relief through the Tax Credit Exchange Program (TCEP), also known as Section 1602, which provides equity for tax credits that are unused in 2009. This program may need to be extended into 2010 to provide equity for some planned projects lacking investor financing. In another example, LIHTC advocates have proposed allowing investors to carry back the tax credits for five years so that the credits could be applied to past profits.

Although these strategies will increase investor demand for credits, additional steps could accelerate the process of stabilizing the market and revitalizing stalled projects. Rather than supplanting private capital, federal actions should also promote private investor discipline in the LIHTC program.

Co-investment Proposal

The U.S. Department of the Treasury should directly co-invest with private investors in LIHTC funds or projects. This strategy would support normal private market investment, including pricing, underwriting and risk management, while doubling the impact of the initial investment. The co-investment proposal includes the following features:

Timeframe – The Treasury would provide matching investments for any LIHTC deals that closed within a specified period of time. For example, the timeframe could be set as either the earlier of an established date (say, Dec. 31, 2010) or when the credits reach a stabilized market price (say, 85 cents per one dollar of tax credits).

Matching funds – The Treasury would provide direct investments on a matching basis in any “9 percent” or “4 percent” LIHTC project. In other words, the Treasury would provide one dollar of federal investment for every one dollar of private investment.

Investment conduit – The Treasury contribution could be provided through multi-investor or single-investor funds or in conjunction with direct project investment. To expedite the process, the Treasury could establish minimum investment levels and offer to prequalify fund managers or co-investors. The administrative process for making these investments could be simplified by relying on the terms and oversight of the private investors. For example, there are a number of existing direct investors and fund managers with proven track records with LIHTC investments. Identifying and “qualifying” these proven participants could bolster confidence in this approach.

Terms and schedule – The Treasury co-investment would have terms and pricing identical to the matching private investment. The federal investment would be made on the private investment pay-in schedule, available upon certification that the private investment had been made in a qualified LIHTC project. As a result, there would be no need for federal officials to select, underwrite or monitor projects.

Zero net cost for government – The Treasury and the private investor would receive identical financial returns. The government would “receive” tax

credits and losses that would otherwise reduce federal tax revenue and would also receive cash distributions. As a result, the Treasury would be a true economic partner. However, the government would be a business partner with no voting rights or control over the project investment.

Co-investment funding – Funding for this proposal could be provided through the Treasury’s Troubled Asset Relief Program (TARP), the American Recovery and Reinvestment Act (ARRA) funds or other Treasury resources. The goal of the co-investment proposal is to stimulate community development and to provide affordable housing at no net cost to the federal government.

Impact

The co-investment proposal would significantly increase the flow of capital into LIHTC projects and, therefore, increase the number of properties financed with private dollars. The initiative would provide equity for deals not currently funded through private investors, while maintaining the investor discipline that has been central to the LIHTC program’s success. The proposal would also stabilize pricing by correcting the current mismatch in supply-and-demand of LIHTCs. Accordingly, the co-investment proposal would accelerate the process of restoring investor confidence and a predictable market.

The cost of the proposal to the federal government would be negligible and would likely produce a net savings for the Treasury. With the current price of the

tax credits at 62 cents to 72 cents (per tax credit dollar over 10 years), or well below the present value of the federal tax revenue, which would have been forgone if the credits were claimed, the proposal would generate a positive net return for the Treasury. In other words, by virtue of the Treasury making these investments, the anticipated IRS revenue losses from these tax credits (currently accounted for in the federal budget) would be eliminated. Therefore, a proposal creates a gain in federal tax revenue. For example, if the Treasury purchased half of the tax credits in a project that had been awarded \$2 million in LIHTC credits over 10 years, the cost and benefits to the Treasury would be as follows:

Investment by the Treasury (\$1,000,000 in credits @ 70 cents)	\$700,000
Tax credits not claimed (\$100,000 per year for 10 years) [present value at 5 percent]	\$772,173
Net gain for the Treasury (benefits exceed cost)	\$72,173

Furthermore, there is enormous public gain from maintaining the affordable rental housing production system and its chief financing vehicle, the LIHTC program. Under the proposal, the cost to the federal government would be negligible. Equally important, the program would be easy to administer as investment decisions would rely on the proven discipline and due diligence of private investors. ■



CREATE A MORE ROBUST LIHTC MARKET BY ATTRACTING INDIVIDUAL INVESTORS

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The universe of Low Income Housing Tax Credit (LIHTC) investors is limited to a small group of large institutions. Since the tax credit was created in 1986, banks, corporations and government-sponsored enterprises (GSEs) have purchased nearly all the credits made available through the program. Unfortunately, the concentration of investor demand in a small group of institutions has introduced volatility to the LIHTC market. Specifically, demand for these tax credits has proven extremely cyclical. As financial institutions and other large institutional LIHTC investors suffer losses (as they have in the current recession), their appetite for tax credits decreases rapidly. The result is a collapse in the price of LIHTCs, which endangers the very feasibility of tax-credit-financed affordable housing projects.

Affordable housing investment was not always dominated by large corporate entities. In fact, individual taxpayers played a prominent role in financing affordable housing development during the early 1980s. That role changed with the passage of the Tax Reform Act of 1986.

Prior to this legislation, individuals could deduct construction period interest and taxes, accelerated depreciation, and amortization of building costs. Taken together, these tax benefits were significant enough to attract many wealthy individuals to the market. By 1986, however, Congress had become wary of overly generous tax benefits, loopholes and deductions. The result was the passage of new passive loss, passive credit and at-risk rules. Among other changes, the new rules established a financial disincentive for individual taxpayers to claim credits in excess of their marginal tax rate multiplied by \$25,000. These rules have not been updated since 1986 and continue to suppress individual demand for tax credit investments.¹

¹ Internal Revenue Code establishes a \$25,000 limitation on passive loss deductions. Individual taxpayers can claim LIHTCs up to their marginal income tax rate multiplied by \$25,000 without offsetting passive income. With a marginal tax rate of 35 percent, for example, the maximum annual credit amount allowed would be \$8,750 (based on Section 469 of the Internal Revenue Code).

Benefits of Individual Investors

Bringing individual investors into the LIHTC market would have several important benefits.

First, bringing individuals into the LIHTC investor pool would stabilize pricing and create a more robust market for the credits. Of course, individuals are not immune from economic hardship. Nevertheless, most people carry tax liability from year to year and, presumably, would benefit from a program that offsets this liability.

Second, individual investors would also help round out the LIHTC market's financing of smaller projects and underserved geographies. Increasingly, large institutional LIHTC investors have dealt directly with affordable housing project developers. To maximize efficiency, investors have sought large projects with correspondingly substantial tax credit allocations. As a result, "it has been difficult to attract corporate investor interest to small and rural deals, since corporate investors look for larger deals with higher amounts of tax credits to offset their federal tax liability," according to the National Association of Home Builders.² Individual investors, by contrast, have lower tax liability than corporations and might be more attracted to smaller deals.

Finally, opening up the LIHTC market to the growing number of individuals seeking social impact investments would diversify the investor pool. According to the Social Investment Forum, "socially responsible investment (SRI) encompasses an estimated \$2.71 trillion out of \$25.1 trillion in the U.S. investment marketplace."³ This growing market indicates that investors are increasingly looking for mission return in addition to financial return. Financial products such as socially responsible mutual funds, positive and negative stock screens, and deposit accounts in community development credit unions are frequently used by individual investors to satisfy both social and financial preferences. Socially motivated individuals might also invest in LIHTCs if given a cost-effective, efficient way of doing so. This would benefit the market by further diversifying the pool of LIHTC investors.

Barriers to Individual Participation in the LIHTC Market

In addition to passive loss tax restrictions, individuals have largely remained outside of the LIHTC market because of four key challenges: high transaction costs, program complexity, compliance risk and the illiquidity of the investment.

² National Association of Home Builders, "Low Income Housing Tax Credit: Stimulus Proposals from the National Association of Home Builders," April 8, 2009, available at www.nahb.org/fileUpload_details.aspx?contentID=114251.

³ Statistic as of 2007. Social Investment Forum, "Socially Responsible Investing Facts," available at www.socialinvest.org/resources/sriguide/srifacts.cfm.

High Transaction Costs

The limited tax benefits offered by LIHTC are often insufficient to offset the cost of individual participation. Tax-credit-financed deals can be multimillion dollar projects. New construction financed by LIHTCs can require raising tax credit equity of 70 percent of eligible construction costs. The cost of soliciting such investment from small-dollar individual investors is cost-prohibitive for most affordable housing developers (and most syndicators, for that matter). Historically, it has been more cost-effective to engage a select group of large investors not restricted by passive loss rules that can finance whole projects on their own.

Program Complexity

LIHTC deals are extremely complex. The technical expertise required to complete a LIHTC project is a dizzying array of real estate, legal, tax, development and policy know-how. Most individual taxpayers lack even a basic understanding of the LIHTC program—let alone how to responsibly evaluate the investment risks.

Compliance Risk

LIHTC investors are subject to credit recapture and penalties should a project fall out of compliance during the first 15 years of its operation. Compliance is a function of the rents charged to the development's low-income tenants. Should rents exceed specific federal guidelines, the project is deemed out of compliance, the credits are recaptured and a penalty is levied. Individual investors have likely shied away from tax credit deals because they lack the expertise to quantify and price the risk posed by this central program requirement.

Investment Illiquidity

The 15-year compliance period, coupled with restrictions placed on the reselling of credits, makes purchasing LIHTCs a relatively illiquid investment. This tends to favor investors with long investment time horizons. Further, the tax benefits that flow from a LIHTC investment only begin when the project is completed. This can be up to three years after the credits are originally allocated. To date, corporate entities with long-term tax obligations have been most comfortable with the illiquidity of the investment.

An Individual Investor Solution

First and foremost, the easiest way to attract individuals into the LIHTC market is to change the passive loss restrictions that discourage individual investment. Whether the passive loss limit is increased or the rule is

eliminated altogether, increasing the tax benefit would make the credit more appealing to individuals. Even with tax reform, however, the barriers outlined above would still discourage many individuals from participating in the program.

While only a partial solution, the creation of a fully transparent online platform to broker the sale of tax credits to individual investors would address some of these challenges, specifically high transaction costs and program complexity. An online marketplace for LIHTC investments would keep the cost of soliciting capital low while simultaneously organizing and communicating important information to potential small-dollar investors. In fact, such technology already exists in the form of so called “peer-to-peer” (P2P) lending. P2P lending sites attempt to lower transaction costs by cutting out the middleman in debt transactions—usually a bank or a credit card provider. While the long-term viability of their core business model is unknown, P2P lenders such as Prosper, Kiva, LendingClub and others have demonstrated that individuals can lend responsibly in the consumer debt market. The same technology could be adapted to match LIHTC investors with affordable housing projects.

Direct Investment Model

The simplest method for organizing a LIHTC platform for individual investors is to directly connect these investors with affordable housing developers that have received tax credit allocations. Developers could post project listings on the platform and the tax credits they have available. As part of the listing, developers would also have the opportunity to promote the project's financial and social merits as well as set the initial price for the credits. The investment period could be designated by a preset date or simply end when sufficient equity has been raised to proceed with the development.

Tax Credit Syndicator Model

A second way to organize an online LIHTC platform would be to use tax credit syndicators. The platform could connect individuals to syndicators who identify and invest in LIHTC projects on their behalf.

There are two reasons to favor this approach. First, it addresses the complexity barrier noted above. Even with detailed project listings, most individuals would be ill-equipped to evaluate the range of risks that come with an affordable housing investment. In contrast, tax credit syndicators have a great deal of expertise and in-house capacity to accurately assess these risks and invest responsibly.

Second, the syndicator model brings economies of scale. It seems unlikely that an online LIHTC platform would ever attract enough tax-credit-savvy individuals to fund more than a handful of deals. Instead, tax credit syndicators could create limited liability investment funds that invest in a range of tax credit deals on behalf of a combination of individuals, corporations, GSEs and other investors. Such a diversified, “high touch” investment approach could finance more LIHTC deals more quickly than would be possible if developers had to rely on individuals to purchase their tax credit allocations directly. In fact, a similar strategy is used by the Calvert Foundation to raise financing for its Calvert Note, a double-bottom-line securities product. Calvert Notes are purchased by institutional and individual investors alike through financial brokers directly from Calvert and on the P2P lending site MicroPlace. A similar multipronged approach could be used to engage individuals in the LIHTC market.

The drawback to the syndicator model for individual investors, versus the direct model, is cost. While the syndicator model would likely make tax credit investments more manageable, syndicator fees would reduce investor yield. Ultimately, the choice between the two models for investors comes down to a tradeoff between complexity and cost.

Conclusion

The recent collapse in the price of LIHTCs has exposed the folly in the market’s over-dependency on large corporate investors. Encouraging individual participation in the LIHTC market would diversify and expand the overall investor pool, smooth LIHTC price cycles, bring untapped capital to the market, and help finance small, often rural, affordable housing developments that today struggle to raise tax credit equity.

An online LIHTC platform, while potentially difficult to scale and develop, would lower transaction and information costs and allow individual investors to enter a market that, heretofore, has been nearly the exclusive purview of institutional investors. Also, such a marketplace could allow for dynamic, real-time price setting. If sufficient scale could be achieved, a price auction mechanism would be effective in either of the models outlined above and, importantly, it would create complete price transparency. Online platform or not, however, the benefits are clear: It is time to get individuals into the LIHTC market. ■



LIHTC: THE DILEMMA AND A SECONDARY MARKET SOLUTION

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The Low Income Housing Tax Credit (LIHTC) market is fundamentally challenged by the lack of a viable secondary market. The substantial impact on available project equity resulting from a collapse in tax credit demand underscores the need for a broader investor pool, more standardization and credible intermediaries.

The creation of a robust secondary market would substantially increase the universe of LIHTC investors and, thereby, increase the supply of new affordable housing. It would provide assurance to potential investors that they would not get “stuck” with credits for their lifetime, especially as their tax needs changed. Creation of such a market would also ensure that the exchange of tax credits remains efficient, with steady availability of project equity through credible intermediaries.

Barriers to LIHTC Investments

Over the past 22 years, the LIHTC program has grown into the dominant financing tool for the development of affordable rental housing. However, the downturn in investor demand threatens the viability of the program. In recent years, the LIHTC program has represented approximately \$9 billion per year in annual credits issued and the production of about 100,000 affordable rental units per year. During the current credit crisis, LIHTC utilization rates have fallen significantly. Some estimates show that less than 70 percent of 2008 tax credits will be used, and the number may fall to 50 percent in 2009.

Falling utilization rates are primarily due to the current lack of investors and difficult pricing environment, not because of a lack of need for decent affordable housing or because of a lack of competition for tax credit allocations.

Recently, the investor pool for LIHTCs has been concentrated among a few large players, including the government-sponsored enterprises (GSEs) and the largest banks. This small investor pool has become even more concentrated during the credit crisis, with many of the players significantly reducing their investments. Until recently, Fannie Mae and Freddie Mac were the largest tax credit investors, making up 40 percent of

the market. These GSEs bought LIHTCs for profit and mission, but are no longer buying new tax credits. There is also a concern that limited capital available for the multifamily sector will be further eroded if Fannie Mae and Freddie Mac conduct “fire sales” of their tax credit book to ease pressure on their balance sheets.

Banks, which are motivated to invest, in part, to satisfy requirements of the Community Reinvestment Act (CRA), have also reduced investment. Compounding the recent reduction in investment is a decrease in buying by other large companies (software, retailers, energy, diversified financials). Because the need to offset profits is uncertain, they see no benefit to investing in LIHTCs.

Other factors affecting investor interest in LIHTC projects are the substantial risks of falling out of compliance and default. While real estate investments traditionally include risk of default, LIHTC investments also include compliance risk associated with a requirement that projects offer affordable rents for 10 years. This requirement translates to a 15-year total investment duration that is often at odds with the tax obligations of investing corporations, which tend to change annually. Such a lengthy time requirement has traditionally been a key barrier to increasing the pool of investors in LIHTCs.

The syndication model currently used for funding LIHTC projects is broken—large, front-loaded fees can no longer be supported and the annual asset management fees are insufficient to meet the increase in workload caused by problem assets. Also, liquidity advances to keep projects current or viable are taking their toll on already-stressed companies in this sector. The nonconforming nature of many guaranteed and pooled fund structures and the low annual compensation makes the sale and transfer of these obligations a difficult, expensive and sometimes impossible proposition.

The recent lack of investor demand has created significant stress in the functioning of the market for LIHTC projects. The price of tax credits has fallen significantly, which has created large equity gaps in project development budgets and few resources to fill them. There are now wide variations from project to project in the median sales price for tax credits. This unstable market in LIHTCs has been further exacerbated by wild fluctuations of yields and tighter debt underwriting standards. Fundamental issues for the LIHTC program remain, even if the market “normalizes” again. Therefore, the development of a strong secondary market for LIHTCs, accompanied by an expansion of the investor base, is essential to its continued viability.

A Secondary Market Solution

Fundamentally, secondary markets mesh the investor's preference for liquidity (the ability to enter and leave the market quickly) with the capital user's preference to have capital available for an extended period of time. LIHTC securities represent a diverse bundle of project investments that could be sold in a secondary market where credits are traded between sellers and buyers. The creation of a secondary market for LIHTC securities would improve liquidity and allow investors the flexibility to tailor their tax appetite for credits while making collected capital available for long periods of time.

Creation of a secondary market would accomplish three important goals.

First, it would attract new investors who are less knowledgeable about real estate projects. The additional benefits of standardization, credible intermediaries and more transparent pricing would attract less-sophisticated investors and enable more rational pricing even in times of credit contraction.

Second, it would draw investors who are interested in shorter investment periods. Currently, many potential investors are dissuaded from LIHTC investments due to the lengthy timeframe of the investment. Creating a secondary market would increase liquidity and the ability to significantly shorten required investment periods, while still providing sufficient capital for completion of housing projects.

Third, it would promote the funding of a more diverse portfolio of projects, including smaller developments and those deemed more complex due to location or other factors. The pooling of projects in securities would spread risk across a broad group of investors, which would ultimately lead to stabilization in the pricing of tax credits.

Stabilizing Pricing

A secondary market option would more accurately price securities for risk than the current syndication model. Furthermore, by creating uniform structures and documents, a secondary market should reduce costs and eliminate the need for multiple parties to do due diligence on the same assets.

Under the current model, LIHTC syndicators collect upfront fees for the sale of the credits and management of the compliance requirements. The secondary market model would relieve fee stress that exists in the current syndication model. A risk-premium would be attached for this asset class, and sufficient asset management fees would then be included in the secondary market structure to provide incentives and align interests. As noted earlier, the current syndication model does not accomplish this and will not likely do so in the near future.

Developing the Secondary Market for LIHTCs

Fulfilling the secondary market solution for stabilizing the LIHTC market would require credible entities, or counterparties, to enter the LIHTC space with securitized products. The logical parties to fill this role are the GSEs and a few other proven intermediaries, including social investment funds (such as Program-Related Investment funds in foundations).¹ The development of a viable secondary market would require both new investors and counterparties who have experience, financial depth and infrastructure to underwrite, structure and asset manage. Furthermore, to be truly successful, this product must become a serious line of business for the intermediary. In other words, it must be a short- and long-term financially attractive proposition based on underwriting and guarantee fees.

The new products would need to offer features that broaden the LIHTC investor pool. For example, LIHTC securities would have to be structured to respond to the market demand for shorter-term investments that match investors' tax-planning models. In addition, the market would need to provide the put-option to guarantee the minimum return and/or the potential for exit at a market-driven price. Therefore, a product design that creates structures to tranche credits by duration, such as five-year and 10-year tranches with a put-option, could solve this problem.

The pool of investors interested in these new products could also be expanded by changes in the tax code. For example, changes to passive loss rules that limit investment by closely held C, sub-S and LLC corporations would allow greater involvement from community banks and other potential investors.

Conclusion

The ultimate goal of creating a secondary market is the development of private-sector mutual funds for retail tax credit buyers. This market could be designed similarly to the existing tax-exempt bond market and the market for mutual funds and municipal and other bonds. Mutual funds could be set up for tax credit retail investors with the pass-through of the tax benefits, liquidity and surety guarantees. This would fill a hole in the social investment world for individuals who want to participate in creating affordable rental housing, but who have only a small amount to invest. If it worked for corporations for 20 years, it can be made to work for individuals as well. ■

¹ For an example of a foundation offering a secondary market product, see Schwartz article.



ENHANCING LIHTC INVESTMENT IN PRESERVATION PROJECTS

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The dramatic contraction of investor demand for the Low Income Housing Tax Credit (LIHTC) that began in early 2008 has stalled hundreds of worthy projects that would help meet the nation's growing need for affordable rental housing. The impact of this capital market contraction is being felt throughout the country. However, as reported by not-for profit developers, lenders and syndicators in *Window of Opportunity: Preserving Affordable Rental Housing*, it has become especially difficult to raise LIHTC investment for projects that preserve affordable rental housing supported by long-term federal subsidy.¹

As part of the *Window of Opportunity* initiative, the Foundation has been exploring innovative financing mechanisms that might be used to address this problem. This article describes the problem's underlying causes and suggests a possible approach that combines a limited third-party guarantee with a senior-subordinate structure, providing additional credit enhancement and accelerated financial return for senior investors. This model could help stimulate LIHTC investment to the benefit of low-income renters living in federally assisted affordable housing.

Preservation of affordable rental housing enables new and existing owners to recapitalize and renovate existing properties already occupied by low-income families and senior citizens. Preservation projects often are prompted by an expiring subsidy contract or affordability restriction. In these cases, the preservation project entails financing a transfer of the property to a new, long-term owner (frequently a not-for-profit organization) who agrees to keep it in good repair with affordable rents well into the future.

The LIHTC is an essential tool for owners seeking to preserve and improve the nation's aging stock of affordable rental housing. According to the National Housing Trust, preservation projects accounted for 52 percent, or 65,000, of the 125,000 units of rental housing financed through the LIHTC program dur-

ing 2007. Over the past five years, LIHTC financing helped preserve and improve more than 280,000 affordable rental homes nationwide.

Three key factors make it especially difficult to finance preservation projects in today's LIHTC market. First, many properties targeted for preservation by local government or mission-driven nonprofit owners are located in smaller towns or weaker real estate markets. Meanwhile, the investors who have remained in the LIHTC market favor new construction projects in a few, robust metropolitan areas on the coasts because they consider these to be less risky.

A second challenge is that preservation projects have depended heavily on the "4 percent" form of the LIHTC, which is available to developments financed by tax-exempt, private-activity bonds. This form of the LIHTC accounted for an estimated \$2 billion of the total equity provided to preservation projects in 2007, according to the National Housing Trust. Although data for 2008 and 2009 are not yet available, the amount is believed to have fallen dramatically, especially because projects financed with "4 percent" credits are ineligible for the two special funding measures approved in early 2009 as part of the federal government's stimulus program.

Third, even before the current market contraction began, investors had grown increasingly concerned that the federal government might fail to renew or fully appropriate funds needed to pay the subsidies promised in HUD's project-based Section 8 contracts. As a result, many LIHTC investors, including Fannie Mae and Freddie Mac (before they entered into government conservatorship in the fall of 2008 and withdrew from the market), demanded that preservation projects establish large, additional cash reserves to hedge this perceived Section 8 risk. Because the price that LIHTC investors pay has fallen from a high of 95-97 cents per dollar of future tax credits to only 65-70 cents today, establishing an extra Section 8 reserve has become even more difficult and makes it impossible to finance preservation projects that are otherwise perfectly sound.

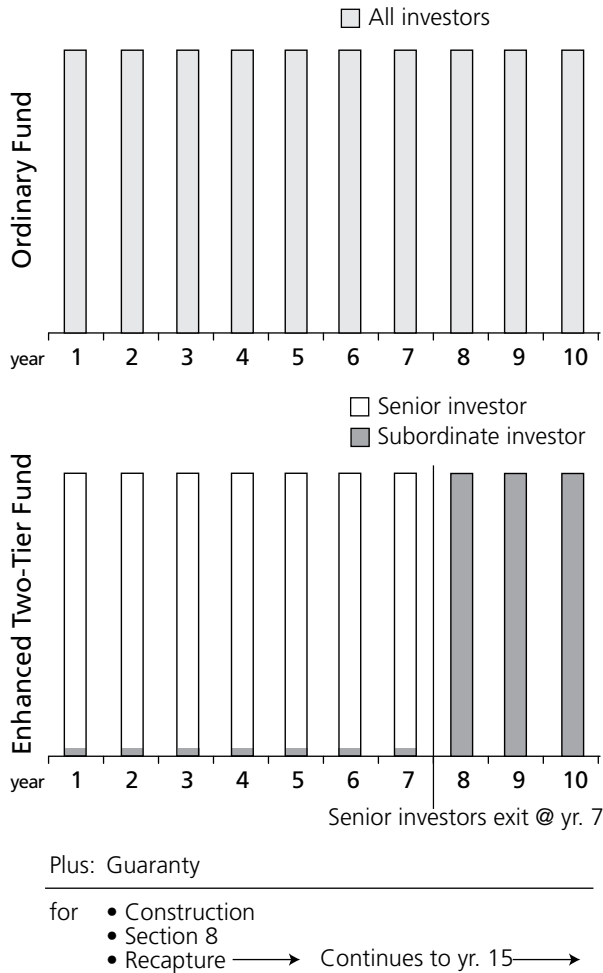
To help preservation projects obtain cost-effective financing in the face of these challenges, the Foundation is exploring an "enhanced" structure for a LIHTC fund that would provide equity for high-quality projects sponsored by leading not-for-profit housing owners and supported through the Foundation's *Window of Opportunity* initiative. This would include projects that use the "4 percent" form of the tax credit and those located outside the country's strongest real estate markets.

The structure for this enhanced LIHTC fund would

¹ The MacArthur Foundation's \$150 million initiative, *Window of Opportunity: Preserving Affordable Rental Housing*, directly supports the preservation of 300,000 units of existing, affordable rental housing nationwide and fosters improvements in policy and financing needed to preserve at least one million affordable rental homes over the decade ahead. For more information, visit www.macfound.org/housing.

Annual Allocation of Tax Benefits

Ordinary vs. Enhanced Tax Credit Fund



combine a guaranty from the Foundation with a two-tier, senior-subordinate capital structure that allows a group of senior investors to shorten their investment horizon by two to three years.² This structure is designed to enable the senior investors (accounting for up to 80 percent of the total fund capital) to exit the fund once they reach an agreed-upon level of return. The fund would be designed to generate this return within a period of seven to eight years versus the 10 years that the LIHTC ordinarily requires.

The shortened investment period for senior investors would be possible because the fund would include a higher-risk, subordinated, limited partner class, providing roughly 20 percent of the fund’s total LIHTC equity investment. The subordinate investor would agree to receive only 1 percent of allocable investment

benefits until the senior investors have received sufficient credits and other tax benefits to obtain their agreed-upon minimum return. Following the senior investors’ exit, all benefits for the remaining investment term (two to three years) would flow to the subordinated investor.

At a time when existing LIHTC investors are increasingly uncertain about their future taxable income and, hence, their ability to utilize future tax credits, a shortened investment horizon has significant appeal. It also would enable the fund to obtain better pricing and thereby deliver more upfront resources for the projects it finances. Importantly, the fund would retain the private sector discipline that has been a hallmark of the LIHTC program’s success to date. The subordinate investor would have a significant stake in the successful performance of the financed properties over the full 15-year compliance period. In addition, the subordinate investor would provide a valuable layer of credit enhancement for the senior investors, ideally making investment easier for institutions new to the LIHTC market. Finally, senior investors would be further protected against certain risks by the Foundation’s unsecured, general guaranty.

Unlike traditional guaranteed LIHTC funds, the Foundation’s guaranty would not be used to ensure a targeted investment yield. Rather, its purpose would be to mitigate specific risks that could cause projects to fall out of compliance with the affordability and occupancy requirements of the LIHTC program and, therefore, not deliver the expected tax benefits to the senior investors or trigger a recapture of benefits that were provided previously.

The Foundation’s guaranty would be capped at a specified percentage of the total fund amount (e.g., 20 percent of the fund size). It could be drawn in the event that sponsor guarantees and various property-level and fund-level reserves were insufficient to cover the cost of (1) shortfalls related to upfront renovations and project stabilization; (2) operating deficits due to the nonrenewal of a federal Housing Assistance Payment contract under HUD’s Section 8 program or the failure to appropriate and pay amounts due under these contracts; and (3) recapture of previously provided federal tax benefits in the event that a LIHTC property is not operated in compliance with all applicable regulations during its initial 15-year period. The construction and recapture guaranty provisions would be available only to the senior investors. Both the senior investors and the subordinated investor would be covered by the Section 8 guaranty.

Based on preliminary discussions, the Foundation believes that this structure offers a feasible way to raise

² The Foundation’s guaranty would be provided through a form of grant-making known as a “program-related investment,” usually a below-market loan or other investment made primarily for charitable purposes. For more information, visit www.macfound.org and www.primakers.net.

LIHTC equity for a wide array of preservation projects on cost-effective terms—despite today’s tight credit environment and diminished appetite for real estate investment of all kinds. Because the guaranty would be limited and the subordinate investor would be positioned to receive a higher return in exchange for a longer investment duration and higher level of risk, the model also appears well-suited to rapid, large-scale replication.

Of particular importance, the Foundation’s Section 8 guaranty would enable the fund to finance properties near the expiration of their subsidy contracts—and therefore at greatest risk of loss from the affordable rental stock. This guaranty should eliminate the need for developers to set aside the large cash reserves that most LIHTC investors now require. For a \$50 million sample portfolio of Section 8 preservation projects

examined by the Foundation, eliminating a special Section 8 reserve gave a \$13 million boost to the properties.

Assuming that the uncertainty and temporary underfunding problems that occurred with the Section 8 program in recent years are reversed, the Foundation expects that market perceptions of Section 8 appropriation and contract renewal risk will lessen over time. Meanwhile, others in the philanthropic, private and public sectors could adopt this new approach, providing the credit enhancement and subordinate investment necessary for worthy projects to proceed. Enabling a healthy volume of preservation projects to build a reliable track record of timely contract renewals and successful delivery of financial returns to LIHTC investors is an essential next step in restoring vitality to the overall LIHTC market. ■

